



THE GOOD, THE BAD AND THE UGLY—THE SEQUEL

This title, from the classic Clint Eastwood western, characterizes what we think is happening and about to happen. We used this title once before, in May '03, when we also had an ugly drawdown, though of a lesser magnitude. In the end, our conviction was vindicated. We believe it will be this time too. Perhaps sooner rather than later.

The Bad

First, let's review the Bad. It's obvious and obviously on everyone's mind. The economy is in serious recession. Worldwide. Likely the longest since World War II. Bad. The U.S. housing sector has collapsed, home sales and prices have been falling since their peak in mid '06. Sales of new homes in the U.S. fell in November to a 17-year low. Housing starts have nose-dived. Foreclosures have risen big time. A quarter of U.S. homeowners with mortgages are underwater, with their houses worth less than their mortgages. Very bad. And credit has dried up. Unemployment is rising everywhere—6.7% for November in the U.S. but likely on its way higher, maybe to over 8%. Corporate earnings are under pressure as consumers get more cautious. Consumer confidence continues to sink. Retail sales are weak and continue to be pressured. Wealth destruction of U.S. households continues, \$7 trillion of net worth lost in the 12 months ending in September '08 and probably rising to \$10 trillion for '08. Deflationary psychology has crept in, discouraging consumers from spending currently, in the belief "stuff" may get cheaper.

Commodity prices have been falling and the mining industry has been hit particularly hard. All metals are trading well below their marginal production cost. Some 85 mines have been closed recently. Credit for smaller companies, and some bigger ones too, has been virtually impossible to obtain. Foreign trade is slowing down. Countries that depend on exports, such as China and Japan, are suffering from declining exports. U.S. exports are declining too, partially from the effects of a higher dollar. Credit Suisse expects global GDP growth of just 1.1% in '09 (approximating the early '80s) with GDP growth in the industrial economies contracting 1.6% and growing in the emerging economies at merely 3.9% in '09, the lowest in eight years. U.S. debt has risen by almost 30% for the year ended September '08. U.S. consumer bankruptcy filings were up 40% for the year ended October '08. All bad.

The Ugly

Markets around the world have dropped, in panic mode. Ugly. The current bear has been almost as bad as 1931 and 1973. Most big cap indexes were down about 40% in '08. Small cap indexes did much worse, as for example the S&P/TSX Venture Composite Index, down 73% in '08, almost all of it in the last 6 months. Value managers have suffered big declines over the past 6 months, with us suffering too, as you well know. Ugly for our clients. Believing, fervently, as we do, that better days are soon ahead, we try to persuade some clients not to break their positions and crystallize losses at what we believe to be the bottom, but rather to patiently hold on so they can benefit from what we believe is an imminent rally in the market, and in our grossly undervalued stocks.

Earnings reporting season is likely going to witness many companies report terrible results for Q4 '08. Ugly, though the market has likely discounted the negative performance.

People losing their homes is ugly. People without jobs is ugly. Bankrupts losing everything is ugly. Charities are having difficulty raising funds. The suffering of their usual beneficiaries is ugly. Madoff's investors, many of them charities and families dependent on him, losing all in a fraud, is ugly. Warren Buffett says, when the tide goes out you get to see who is swimming naked.

Important world class investment banks, such as Bear Stearns and Lehman Brothers, disappearing, is ugly. The biggest U.S. insurer, AIG, imploding, is ugly. The biggest brokerage firm in the world, Merrill Lynch, being devoured, is ugly. The U.S. auto industry, on the verge of failing, is ugly. The State of California, running out of money, is ugly.

The recession, credit crunch, housing slowdown and bear market have been made really ugly by the media, which amplifies it, with comparisons with The Great Depression, and rhetoric like "meltdown", "abyss", "tsunami", "Armageddon".

A grotesque backdrop during these ugly economic times are the constant, violent cruelties of fanatical terrorists and the seemingly futile and endless wars against them.

The Good

We are all inundated by the media with the Bad and the Ugly. The Good is obscure. Principally because it is less obvious and its benefits will only be revealed prospectively. But the Good is nonetheless real and we, as investors, need to be positioned to capitalize on it.

There have been many recessions over the last 100 years and, of course, a depression in the '30s. In the latter case, perhaps what could have been an ordinary recession was exacerbated by wrong policy responses—monetary tightening instead of relaxation, trade barriers instead of trade encouragement and no safety net for the unemployed.

All downturns are cyclical and allow excesses to be corrected and the forces for inevitable recovery to be strengthened. This one is more challenging because the leverage of the banking system got so extreme, financial derivatives became so exaggerated, the housing bubble in the U.S. and elsewhere so pervasive and consumers so extended, that the correction is turning out to be deep and violent. What is not known is its duration. Some believe it will end in the middle of '09. The pessimists believe it may be several years. MIT professor, Lester Thurow, believes America's recession will be "V-shaped—sharp but short, and recovery will begin next autumn."

Today, monetary and fiscal stimulus by governments and central banks around the world has been large, swift, coordinated, with much more likely to come, including a \$775 billion stimulus package planned by President-elect Obama. "Bailouts", "relief programs", "infrastructure spending", are the buzzwords of the day.

Most recessions, such as in the early '80s, start when the Fed raises rates to stop economic overheating or inflation by removing the punchbowl from the party. Today, the Fed is bringing in the punchbowl and filling it to overflowing. The monetary base is rising big time. Fed funds were recently lowered to a range of 0 to 0.25%. Free money that banks can borrow from the Fed and lend to consumers and businesses whenever banks feel inclined to lend again. And they will. It's their business. Borrowing short at low rates and lending to customers at higher rates, to make the "spread". Though this time they'll likely be more disciplined. The yield curve has not yet obliged as it has flattened, with 10-year U.S. treasuries yielding only 2.5%, from the inordinate demand for risk-free assets and the spectre of deflation. Lending institutions need a steeper yield curve to prosper. It's coming.

The panic is subsiding. It is manifest in the significant drops in LIBOR, the rate at which banks lend to one another, and in the TED spread (the difference between LIBOR and U.S. T-bill rates), a good barometer of creditor fear.

30-year mortgage rates, now at just 5%, seem headed to a record low. Combined with lower prices, housing is becoming eminently affordable. With U.S. mortgage rates and property taxes deductible, home ownership will compete very favourably with renting. Government will make credit available too. Not just for houses but for autos too. GMAC just got bank status and \$5 billion to assist it in its credit operations. Applications for mortgage refinancings are very high as owners rush to reduce mortgage costs. The inventory of unsold homes is declining. All good.

As U.S. consumers cut back on spending, their savings rate is rising, now over 2% (by contrast, China's savings rate is 25%, a potential for serious consumption demand to be unleashed). Liquidity generally is rising. Liquidity as a percentage of household assets is at a record high, even though many household balance sheets leave something to be desired. What is missing is confidence. The rally in stocks we envisage in the months ahead should in itself give investors and consumers more confidence.

Gas prices, at 3-year lows, are helping consumers big time. Spending by U.S. consumers on gasoline has plummeted from over \$1.6 billion per day to \$600 million, adding \$1 billion per day to their spending power. Good.

As demand slows, retailers, including autos, and their suppliers, are taking steps to reduce inventories. This means attractive prices for their customers. The cost of living is declining. Spend less, save more. Auto companies plan to shut down in January to reduce costs and inventories. In the near term, lower inventories mean lower GDP, but as confidence and consumption return, depleted inventories will have to be replenished, a stimulus for future production and future GDP.

Many businesses are set to fail. Early '09 will witness the bankruptcy of many retailers, especially smaller ones. But in all industries, the survivors will get a lift from the reduced competition. Circuit City is in Chapter 11 and, after its inventories were cleaned out during the Christmas season, may not survive—a clear benefit to Best Buy whose market share would be enhanced. GM is expected to slash the number of its brands in half. Less competition for Ford and Toyota. But, even with a smaller market share, a leaner, meaner and stronger GM too.

Lean and mean is good. This downturn is forcing business, whether financials, manufacturers, retailers or service industries, to cut costs by eliminating unprofitable lines, stores, divisions and employees. Productivity is improving but will really show up once future revenues head up. Margins will be enhanced and bottom line profits could soar. Lower cost of borrowings and tax relief will help too. Good, good and good.

On the resource side, supply destruction is at work. Mine closures, cutbacks and reduced production and capital spending will ultimately create bottlenecks and shortages. It takes a lot longer to reopen a mine than to close it and to expand the production of oil and gas, already a fast depleting resource. Shortages of food, worldwide, could also develop with inventories at the lowest levels in 50 years.

Though deflation is now the generally perceived outcome, all of the reflation occurring throughout the world should translate into more inflation. If inflation is a monetary phenomenon it could come in with a vengeance as the supply of money ratchets up. In our view, the recently strong U.S. dollar, propped up by a flight of some \$400 billion by foreign investors to the least risky asset, U.S. treasuries, is set to weaken. The strong dollar has been deflationary, reducing the prices of imports and restraining U.S. exports.

Fed Governor Bernanke, a student of the Depression, knows that deflation is anathema to recovery and that inflation is the more desirable alternative if consumption is to revive and the U.S. is to remain competitive. The Fed's balance sheet is expanding at the fastest pace on record. The U.S. is set to have a record budget deficit and significantly rising national debt as a percentage of GDP. And it will need to borrow around \$2 billion a day to finance its current account deficit. At current depressed interest rates, and already holding an excessive amount of dollars, foreign central banks may shun U.S. treasury offerings, leaving the Fed as the ultimate buyer—and creating the supply of excess money to generate inflation. And weaken the dollar. Both of which are currently desirable. And both of which the Fed likely wants. The name of the game is help the borrower, never mind the lender. So, in the end too, foreign holders of all that U.S. government debt will likely be repaid in cheaper dollars.

Commodities, mostly denominated in dollars, will get cheaper for everyone, except Americans, increasing foreign demand. U.S. assets, including depressed real estate, will get cheaper for foreigners, increasing their demand. The U.S. trade deficit will improve with U.S. competitiveness. Better for GM, worse for Toyota. U.S. multinationals will benefit as they sell more abroad and their repatriated foreign earnings are translated into more U.S. dollars. The yield curve will steepen as the demand for U.S. treasuries weakens from fear of a weaker dollar and of inflation, and lending institutions will reap their traditional benefits of borrowing cheap, short, and lending expensive, long.

Gold and silver should be big beneficiaries of the reflation consequences. But all commodities too. So too, resource stocks, which at their current depressed prices have limited downside. Good, we own them.

A new U.S. administration, with a popular incoming President Obama and his impressive new economic team, already hard at work during the transition, is good.

While the emerging countries such as China and India are hurting too, their emergence is a secular phenomenon which ultimately will reassert itself when the cyclical downturn exhausts itself. Those economies will also have to shift from exports toward greater internal demand. Secularly good.

Oh, and The Beautiful

So, it's not part of the movie title. But we need to make the point that while there are things going on in the real economy that are potentially good, there are things that relate to stocks that are utterly beautiful.

Without question, in their beaten up mode, stocks are the cheapest—no, the ultimate—asset class today. Corporate bonds are a close second.

It's been said, there's always a bull market somewhere. For sure it has recently been in risk-free treasuries. T-bills are yielding nothing—a place for the fearful to park cash. Treasury yields have been falling for 28 years to recent record lows, today 1.7% for the 5-year, 2.5% for the 10-year and 3.0% for the 30-year. The panic into risk-free assets isn't just a mere bull, it's a bubble. And, like all bubbles, it will eventually burst and cause pain. Warren Buffett warned in October: "Today people who hold cash equivalents feel comfortable. They shouldn't. They have opted for a terrible long-term asset, one that pays virtually nothing and is certain to depreciate in value. Indeed, the policies that government will follow in its efforts to alleviate the current crisis will probably prove inflationary and therefore accelerate declines in the real value of cash accounts."

In the meantime, risk assets—equities, corporate bonds, commodities, and even real estate—are cheap. The yields on corporate bonds, and especially junk bonds, relative to comparable U.S. treasuries have never been better. The price of the average high-yield bond fell 35% from May '08 to December '08. Our income accounts have been similarly affected, but still provide a 9% current annual income and an equivalent annualized capital gain potential.

Stocks are as cheap today as they've been since '74 and '82, or, maybe ever. The earnings yield on the S&P 500 at 9% is as huge a premium to U.S. 10-year treasuries as has existed, maybe ever. The S&P 500 enjoys a 3.1% dividend yield, the highest premium to the meager 2.5% on 10-year treasuries since the late '50s. And the S&P 500 trades at just over book value—as beautiful as it gets.

A value investor's grab bag. Many growth stocks are trading like value stocks, reasonable multiples relative to growth rates and the overall multiples.

Many stocks (apparently, as many as 2000 notes Bloomberg) recently traded for less than their current cash or their net working capital, giving you a gift of the rest of the business. Absolutely beautiful.

Clearly, given the decline in profits, most businesses are worth less in this period—although historically low interest rates are boosting valuations big time as the discount rate, used to present-value a business' future cash flows, has fallen concomitantly.

And lots of the cash parked in those risk-free assets earning zip will ultimately come back to play. \$3.7 trillion in money market funds, a record amount of cash relative to the value of stocks. And lots of cash being held by hedge funds, itching to be reinvested, hopefully not redeemed.

Balanced funds, now underweighted in equities, will be required to buy equities and sell fixed income in order to rebalance to their mandate. We think stocks made their real low in the panic on October 10th with 2900 new lows when the Dow hit 7883. A retest on November 21st at a lower low of 7450 had 1000 fewer new lows. From almost every technical standpoint the market is on its way to recovery. Our own SVATM work also suggests the U.S. markets bottomed at a significant floor at that time, and have bounced, giving a Buy signal. There may be retests, but the worst is likely behind us. The TSX Venture Index, to which we seem to be currently mostly correlated, has begun to rebound—6 consecutive up days, for a 25% bounce off the bottom.

Governments want to help equity markets. There is pressure on the SEC to reinstate the rule permitting short-selling only on upticks. Governments and central banks may actually buy equities. In Canada, mandated withdrawal from Registered Retirement Income Funds (RRIFs), was reduced by 25% for '08 to alleviate the necessity to liquidate. Beautiful.

Capital gains in stocks are already treated more favourably than returns on bonds. Look for even more favourable treatment.

This tax-loss selling season was a frenzy, especially in Canada, where capital losses can be carried back for 3 years, and everyone wants a refund. It's now, thankfully, over. And the rebound is underway now that the pressure is off.

We think most of our individual holdings are beautiful. Little downside and huge potential for reward. Punished for being public and smaller. Our major positions have good balance sheets, good prospects for '09, many trading at less than 25¢ on-the-value-dollar, with nothing attributed for growth. Potential four baggers. We need that to help get back toward our old highs.

We also believe that we are in the right groups, the beaten up resource area, particularly oil and gas. Natural gas prices are close to production costs, the rig count is collapsing and depletion rates are some 20-30%. Nearly a third of production is used for power and a significant amount for heating. Easily understood companies producing essential commodities.

And while many big-cap companies are fabulously attractive now, few have the reward potential of our smaller-cap holdings. Smaller-caps, historically, have outperformed larger-cap companies. We think this historical trend will hold in today's environment where the smaller-caps have suffered the most, and could significantly outperform going forward. Moreover, there is also a seasonal effect when small-caps outperform big-caps from mid December until the end of January because the end of tax-loss selling and year-end portfolio window dressing by institutional investors tend to have a bigger impact on small-caps that have suffered a large year-end drawdown. Early in the New Year, the institutional investors then replace some big-caps with small-caps which have the greater upside potential. Look for upside gaps from scarcity of offerings. Look for some to be acquired, or to merge in some synergistic, value added form.

Needless to say, we will, as opportunity presents, weed out any weak names, and in the recovery period, emphasize, if we can, larger-cap names where the value presents itself and our SVA™ work can be used effectively.

The market has already priced in all the negative news, and then some, so the real “surprises” won't be more bad news, but any good news. The downturn in the latter part of '08 was so severe that it shouldn't be hard for companies in '09 to surpass those '08 comparables. Vince Farrell noted that since World War II there have been seven times when the 3-month weakness in unemployment was comparable to current levels. In every one of those seven times, one-year later, stocks were higher by an average of 21%. Remember that the best news is made at market tops—the worst at bottoms. Remember, too, the news doesn't have to be good, just better than what's expected. Remember, finally, all we need for a meaningful rally to develop is for the selling pressure to abate—and this is one sold out market. Wouldn't the ultimate surprise be that the downturn is followed by an earlier than anticipated recovery, with a boom in corporate earnings from a lower dollar and higher inflation. “Go ahead, make my day!”

A Fistful of Dollars

Successful investing is all about comparing risk to reward. Every asset class bears risk, even cash, as Mr. Buffett points out—from getting repaid in deflated dollars. As for our equity holdings, two of them, representing a very small weighting, have risk relating to their long-term viability, from their debt levels and access to capital to finance growth. Their depressed share prices reflect those concerns.

The balance of our holdings, though, are down mainly because the whole market is down, from the negative psychology, deleveraging and redemptions—hedge funds, mutual funds, commodity funds, institutions and individuals—all running from stocks. Lower commodity prices haven't helped either.

Yet, our overall holdings continue to possess similar values to our appraisals of many months ago. Notwithstanding their excessive discounts from those appraisals, their stock prices, until a few days ago, had continued to decline. For example, *Corridor Resources* still has a proven and probable reserves value twice its current share price. And, our assessment of the risk-adjusted asset value of the company, which includes potential from exploration, is still more than 4 times higher than today's share price. The company has no debt and significant cash flow to cover its planned growth capital expenditures. We are astonished by *Corridor's* low trading price, especially in light of natural gas prices which remain at C\$7, in line with the company's budget. So, the business is fine, but its share price is not, a disconnect for sure. In '07, the company cash flowed \$19 million, '08 should be over \$40 million and '09 should be in excess of \$60 million. Beautiful growth. And a huge potential shale gas play thrown in free.

Orca Exploration trades at less than 3x 2010 expected earnings, and well below its appraised value. It too is debt free. With about 2 TCF of reserves, *Orca* also has value that is over 4 times higher than today's share price. And, in its two most recent press releases, the company has alluded to the potential monetization of assets—so we may not need to wait for the stock market to recognize the fair value if a more sophisticated industry buyer takes advantage of it sooner.

Canadian Superior, *Petrolifera Petroleum* and *Sterling Resources* all trade at less than 20¢ on-the-value-dollar. *Canadian Superior's* two recent successful exploration wells in Trinidad added several dollars to the company's asset value, yet the share price hovers just above one dollar. Results from a third well in Trinidad are forthcoming shortly and could continue to drive the asset value higher. *Petrolifera's* Argentinian assets alone are worth more than 4 times the share price. It trades around 1.5x expected cash flow which comes entirely from Argentina while the world class potential from the significant exploration prospects in Colombia and Peru are completely ignored. *Sterling*, another debt-free company, recently announced a farm-out of some of its Romanian assets allowing the company to maintain a significant stake while the farm-in partner bears the brunt of the capital spending over the next few years. We anticipate a similar announcement in respect of the company's valuable North Sea assets.

Canadian Phoenix and debt-free *Canoro Resources* both trade well below their net asset values at about 25¢ on-the-value-dollar. The net asset values of both have fallen somewhat from lower energy prices, though still remain significantly above current share prices. As the commodity prices rebound and the companies continue to add value, we expect the share prices to more closely resemble economic reality.

While our call on gold bullion has been correct, our call on the stocks has been restrained by the poor market. *St Andrew Goldfields* and *Etruscan Resources* have both been depressed as they've been seeking capital. *St Andrew* requires about \$30 million to enable it to go into production later this year. *Etruscan* just completed a \$5 million debenture financing allowing

the company time to advance its plans. Both of these companies trade at less than half of their net asset values, and both have solid exploration prospects too.

Walgreen, like most other big cap stocks, traded at or above fair value for over 10 years until early '08. Remarkably, its current share price is virtually unchanged from the beginning of that 10-year period, even though the company has grown its Fair Market Value by about 14% per year over that duration—almost four fold. As the market declined in '08, Walgreen's share price got as low as 50¢ on-the-value-dollar and is now still selling at only 60¢ on its growing value-dollar (sales were up 10.8% in December '08 from December '07).

In our last letter (October 21) we commented that, in the past, we've occasionally seen individual stocks fall to 25¢ on-the-value-dollar, but never an entire portfolio of stocks. Yet since that letter, our portfolios fell even lower. But, clearly, downside price risk continues to diminish the farther our stocks trade below their Fair Market Values, with the potential upside now being greater than we've ever seen. In the main, the companies we hold are well financed, most have no current material need to access additional capital, and, while growth plans may have been curtailed, they're still growing. It would not take much for the share prices of many of our holdings to double and triple from these depressed levels, and most would still be well undervalued.

Looking Ahead

We need to make up lots of lost ground. We think we will, more quickly than you might believe, given the extraordinary return potential of most of our holdings, many with 3-year *annualized* return targets well in excess of 50%. This is supported by the Value-Line Appreciation Potential, which as noted by the Hays Advisory Letter, is currently at the same hugely prospective level as witnessed only twice in the last 50 years, and has “an amazing strong correlation with future market performance”. The recent healthy bounce off the late December lows is a good start.

2008 was an ugly year and we hope that 2009 will be the beautiful year you and we wish for, in every respect, including good health, peace of mind and prosperity.

Herbert Abramson and
Randall Abramson, CFA
January 6, 2009

The information contained herein has been drawn from sources which we believe to be reliable; however, its accuracy or completeness is not guaranteed. This report is not to be construed as an offer or solicitation to buy or sell any of the securities herein named. Trapeze Capital Corp., its affiliates and/or their respective officers, directors, employees or shareholders may from time to time acquire, hold or sell securities named in this report. E.&O.E.